Congress of the United States
Washington, DC 20515

February 10, 2003

The Honorable Harvey L. Pitt
Chairman
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

Dear Mr. Chairman:

We are writing to request that you and the other members of the Securities and Exchange Commission take action to reverse the recent SEC decision that permitted accounting firms to continue their practice of marketing tax shelters to audit clients. We believe that a reversal is urgently necessary to prevent further erosion of investor faith in the market.

In its initial proposed rule, the SEC accurately stated the reason for banning the practice of marketing tax shelters to audit clients. “Provision of these types of services may require the accountant to audit his or her own work, to become an advocate for the client’s position on novel tax issues, or to assume a management function.”

It is very difficult to understand the rationale for the decision to ban consulting services but permit the marketing of tax shelter strategies to audit clients. Providing tax shelter services poses far greater risks of conflicts than providing consulting services. Auditors are rarely called upon to certify the quality of consulting services and do not have to defend those services from attack by governmental agencies. However, the reverse is true for tax shelter services.

The recent publicity surrounding the sale of aggressive tax shelters by Ernst and Young to executives of Sprint adds a new troubling dimension to this issue. Ernst and Young, and presumably other accounting firms, seem to have been marketing tax strategies to executives that have the effect of shifting tax liability from the executive to the corporation. Quite simply, these transactions may have provided tax benefits to the executives at the expense of the shareholders in the corporation.

As you know, an executive who exercises a non-qualified stock option is required to include in income the difference between the option price and the fair market value of the stock at the time of exercise. That gain is treated as wage income and is subject to both income tax and payroll tax. However, the corporation is entitled to a business deduction for the amount included in the income of the executive.

Ernst and Young has marketed several tax strategies to executives to avoid tax liability on stock option exercise gains. At least one of those strategies, the ECS strategy, involves a transfer by the executive to a family trust or partnership. The purpose for the transfer is to hide the income from the Internal Revenue Service. If the strategy were done directly by the executive, the executive would have both an extremely large gain shown on the tax return and an extremely large deduction. It would be an invitation for an audit. Instead, the transaction is done in a trust or partnership with the result that the income is not reflected on the return and the likelihood of audit is much less.

One consequence of this evasion technique is that the deduction at the corporate level is either lost or indefinitely deferred. The executive's tax benefit is paid for by the shareholders of the company.

It is likely, but not certain, that the Sprint transactions involved a transfer of the options with adverse consequences to the Sprint shareholders. These transactions work only if they can be hidden from the IRS. However, it is certain that Ernst and Young has marketed such transactions to executives with stock option gains. The fact that an accounting firm may be marketing strategies to executives of an audit client that seem to have the effect of benefitting the executives to the detriment of the corporation requires urgent action.

Taking action to reverse the recent SEC decision or encouraging your successor to do so could be one way of ending your tenure on a positive note. We urge you to do so.

Sincerely,

Richard E. Neal
HON. RICHARD E. NEAL

Edward J. Markey
HON. EDWARD J. MARKEY